TD Economics

Special Report

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CENTRAL BANKERS NEED THICK SKIN

Various media reports have noted criticism from a number of economists on the Bank of Canada's decision of July 11th to leave its key policy interest rate unchanged. Some criticized the rate decision itself while others exclaimed surprise and disappointment that the wording of the Bank's statement had "limited room to manoeuvre" or "boxed in" the Bank should the need to raise rates become apparent. These reports lead me to think that TD Economics should clarify its position lest we mistakenly be thrown into the camp of dissenters. We think the Bank of Canada made the right decision and do not share the view they have inappropriately compromised future policy flexibility. A call from my mother last night made it a prerogative to express our view. She assumed TD Economics was also critical of the Bank of Canada and challenged this position, noting that "David Dodge is a very smart man and should know what is best for the economy". In this case at least, I agree with the Bank of Canada and my mother.

The Governing Council of the Bank of Canada must find the criticism of their July 11th decision and statement ironic because many of the same economists have been warning for several months that the Bank must be cautious not to fall into the classic trap of monetary overshoot. This arises because of the lags between changes in interest rates and economic activity and inflation. If a central bank continues jacking up rates until it sees tangible evidence of inflation pressures cooling then it has tightened too far. This is a fairly prevalent policy pattern from the past. The monetary overshoot then results in excessive weakening of the economy. To minimize the risk of overshoot the monetary authority needs to base rate-setting decisions on its predictions of future economic activity and inflation. This is exactly what the Bank of Canada did on July 11th. They forecast that a slowing U.S. economy and a relatively strong Canadian dollar will weaken growth in Canada and this will keep core inflation at their 2 per cent target. Hence they very legitimately concluded that a further interest rate increase is not required.

It takes courage and conviction to operate monetary policy in a forward-looking manner. Niels Bohr, a Danish physicist who won the Nobel Prize, said that "prediction is very difficult, especially about the future". Perhaps of even greater relevance to the Bank of Canada's dilemma we should look to Yogi Berra's comment that "the future ain't what it used to be". The tight labour market of recent months and the surge in core inflation in May appear to be the main factors leading some to call for another interest rate hike. But these results were the product of monetary conditions of some time ago. The same activity and inflation pressures may not necessarily apply 12 to 18 months in the future. Indeed, in the July 13th Monetary Policy Report Update the Bank forecasts that under the current level of the key policy interest rate, real GDP growth will slow from 3.2 per cent this year to 2.9 per cent in 2007 and 2.8 per cent in 2008. This, in the Bank's view, will bring convergence of actual to potential output by the end of 2008 relative to the estimate of 0.4 per cent excess demand in the second quarter of this year.

There are two noteworthy aspects of the Bank's view of the gap between actual and potential output. First, it does seem a bit odd that the Bank would tolerate, even apparently support, the existence of excess demand for another two years. One might have thought that they would want to act to bring output back to its potential more quickly than this. That would naturally require driving output growth

below its potential for a period. However, it should be noted that the issue is largely of the hair-splitting nature. The Bank estimates that the degree of excess demand will be very slight and as they go to great lengths to emphasize, a fairly wide confidence band must be applied to the potential output estimates and hence the gap. Further, despite the slight degree of excess demand, the Bank forecasts that core inflation will remain at 2.0 per cent. Perhaps there is a view that with some further, lagged pass-through to prices of the exchange rate appreciation that has already occurred and with changes in the world economy the inflation target is not jeopardized by a slight degree of excess demand.

The second noteworthy aspect of the Bank's comments on potential output is that the upward revisions to labour productivity for 2005 (originally reported by Statistics Canada as 1.1 per cent growth but now standing at 2.2 per cent) have given the Bank greater confidence in its projected path of potential output. Following their explanation in a previous Report of how potential is derived, we were quite struck how volatile the measure could be and how, in particular, it could be knocked down over the projection period if actual labour productivity did not substantially rise from what appeared at the time to be the pace. Of course the current figures for 2005 suggest productivity did pick up, but the growth rate likely fell back somewhat in the first half of 2006. The Bank's projections of potential output growth of 3.0 per cent for both 2007 and 2008 conform to the fairly traditional "rule-of-thumb" most economists use.

While we feel the decision to leave the key policy rate at 4.25 is appropriate, it would be silly to suggest there is no valid case for an increase. First, there is no way any one can make a sharp distinction in growth or inflation prospects over a 25 basis point interest rate difference. Second, from almost any perspective the aggregate Canada-wide data suggest the Canadian economy is pretty hot at this time. Growth could run faster than in the Bank's forecast although this is not TD Economics' bet. Indeed, our Canadian growth forecasts of 3.0 per cent this year and 2.7 per cent for 2007 are slightly weaker than the Bank's. Even if the Bank's growth scenario plays out, inflation could run hotter than predicted.

In other words, the Bank of Canada's forecast, just like anyone else's, could be wrong. It could be wrong in its depiction of slowing growth. And it could be wrong in the expected inflation dynamics. So, has the Bank downplayed these risks and used words that compromise its future flexibility in changing rates if the need arises? An answer in the affirmative would have to be driven by a view that the Bank has said something to close its future options. The relevant sentences from the July 11th release are:

In line with the Bank's largely unchanged outlook, the current level of the target for the overnight rate is judged at this time to be consistent with achieving the inflation target over the medium term. The Bank will monitor global and domestic economic and financial developments, including adjustments in the Canadian economy, relative to its projections.

Some seem to interpret this as a strong statement of Bank of Canada intent to leave interest rates unchanged for a very long period. But that is not what is said. First, it is clear that interest rate conditions are conditional on how the world unfolds relative to the Bank's forecast. And the Bank will be closely monitoring the situation for any deviation from forecast. In short, if the growth profile or the inflation dynamics deviate from expectations, the Bank can and will step in to change interest rates to ensure their 2 per cent inflation target is achieved. Second, this is their view "at this time". Every other forecaster changes perspective over time. Why should the Bank be any different? New information becomes available and thinking advances.

A possible reaction to the above assertions is that the Bank of Canada's main statement from the July 11th release says nothing. In this view, it merely boils down to implying that if everything unfolds the way they predict then the target interest rate does not need to change but that if things don't unfold that way then the target interest rate will need to change. In my opinion, that is a correct interpretation of what the Bank is saying. Further, I think there is a lot of value-added in the statements. A bit of context is first required to understand why. For some time the Bank has been releasing economic forecasts. The additional transparency is admirable, but the forecasts have largely been irrelevant. One knows that the forecast has to show output returning to potential and inflation tracking to the 2 per cent target. To show anything else would imply gross negligence towards the Bank's objective. What wasn't known was the path of interest rates the Bank be-

lieved would be required to realize these outcomes. Without that key information the forecasts gave us precious little information. But now we have a fairly clear expression that the Bank believes the forecast outcomes will be realized with the target rate remaining at 4.25 per cent. As such, we have been given a view inside the box that until now has been black. We can make meaningful comparisons of the Bank's forecast with other projections.

In conclusion, I think the decision to stand pat on the target rate was the right move. I don't see anything in what the Bank has said that should compromise their ability to raise rates should that be required in future. Sure there would be howls of protest with accusations that the Bank has been misleading. But having tough skin and possibly being a bit hard-of-hearing are requirements of a central bank job. The accusations would stem from what I believe is a misinterpretation by many of the key parts of the Bank's statement. That being said, if public statements are misinterpreted, there is some onus on the communicator to rectify the situation. To that end, the Bank of Canada might wish to clarify that they are not ignorant of the inflation risks present in the current situation and that yes, if pressures mount relative to their current expectations that obviously they would raise rates further. I would have thought that went without saying, but maybe it doesn't. The view of TD Economics, in light of our softer growth forecast than the Bank's, is that this is the peak in the interest rate tightening cycle and the next move will be a cut toward the end of this year. But we certainly attach a significant weight to the prospect of inflation pressures mounting above our base case view and hence do not think there should be a view that further interest rate increases are out of the question.

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